OFR PRESS RELEASE

OFFICE OF FINANCIAL RESEARCH

12/2/2014

Office of Financial Research Cites Rising Risks

Third Annual Report to Congress Identifies Threats to U.S. Financial Stability That Have Risen in Past Year

WASHINGTON – The Office of Financial Research (OFR) submitted its *2014 Annual Report* to Congress today, citing threats to the stability of the U.S. financial system that have risen in the last year.

The annual report, issued five years after the end of the financial crisis of 2007-09, highlights three specific areas of concern:

(1) Excessive risk-taking during an extended period of low interest rates and low volatility,
(2) An increase in market fragility resulting in declining market liquidity and persistent risks of asset fire sales and runs, and
(3) The migration of financial activity away from banks toward less regulated parts of the financial system where threats could be significant, but are more difficult to assess.

"Threats to financial stability are moderate, our tools for spotting them are better, and the financial system in many ways is more resilient compared with just before the financial crisis," said OFR Director Richard Berner. "But as the financial system evolves and innovates, we must be especially watchful for important new vulnerabilities that are emerging in dynamic financial companies and markets."

The report notes that, in addition to those new vulnerabilities, gaps remain in the analysis, data, and policy tools aimed at spotting and addressing them, despite progress in narrowing those gaps. Moreover, it notes that many new policy tools designed to make the financial system stronger and more transparent are still largely untested and may have unintended side effects. And the development and implementation of other policy tools to respond to threats to U.S. financial stability remains incomplete.

The report fulfills a requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 for the OFR to assess the state of the United States financial system annually and analyze threats to U.S. financial stability. The Office previously submitted annual reports to Congress in 2012 and 2013.

The Dodd-Frank Act created the OFR to serve the public and support the Financial Stability Oversight Council and its member agencies by conducting research and analysis, collecting and standardizing data, and developing best practices in financial risk management.

The OFR has grown beyond start-up mode to a more mature organization with more than 220 staff members and a strategic plan to set priorities and track performance to fulfill the OFR mission.

Highlights of the OFR 2014 Annual Report include:

- A discussion of "Analyzing and Monitoring Threats to Financial Stability," with the OFR's Financial Stability Monitor as the centerpiece. The OFR introduced the monitor in last year's report, but refined, broadened, and deepened it for this report. The monitor displays the state of financial stability and the buildup of vulnerabilities across five broad categories of risk based on a set of models, surveys, financial data, and other indicators. In addition to assessing risks rising within the financial system, the monitor shows heightened risks to nonfinancial corporations in the United States due to relaxed lending standards, declining credit quality, and higher debt levels in relation to total assets. The chapter also identifies activities, such as leveraged lending and mortgage servicing, that have migrated away from banks to less resilient parts of the financial system.

- A discussion of the benefits and challenges of new policies to enhance financial stability, most of which focus on the largest, most complex banks or nonbank financial firms designated for enhanced supervision. Although the OFR is not a policymaking entity, the Dodd-Frank Act directed the Office to provide analysis and advice about policies for curbing risks to the financial system. In particular, the chapter evaluates the state of the art of stress testing, with important suggestions for improving this critical tool. It also assesses the pros and cons of regulations requiring more capital and liquidity for banks, which are intended to strengthen them, but may have unintended consequences and could foster the buildup of risks in less regulated parts of the financial system. The chapter also evaluates the risk-retention rule issued in October by federal financial regulators for issuers of securities backed by mortgage loans to have "skin in the game" by retaining an interest in the performance of their securitized loans.

- A summary of three significant OFR research initiatives, including a project that uses agent-based models to simulate the spread of fire sales in financial markets during crises. These models hold promise for understanding the dynamics of risk transmission across the financial system. In a second project, OFR researchers explore effective and innovative visualization techniques that reveal key patterns and connections in complex financial data. A third project uses data available to the OFR from the $26 trillion credit default swap market to analyze the role of information flows on the pricing of derivatives and to explore how transaction sizes affect prices and liquidity under different market conditions.

- An assessment of progress and challenges in developing and implementing financial data standards, which are essential to providing high-quality data for the benefit of policymakers and industry participants. Progress is notable in the significant milestones reached in 2014 on the global initiative to establish a Legal Entity Identifier (LEI) — a linchpin for making connections in the massive volumes of financial data that course through the international economy every day. The chapter also describes OFR work to develop identifiers for financial instruments and products, and the organizing framework to enable their use. In addition, it outlines the ways the OFR is helping the Commodity Futures Trading Commission and other regulators improve data quality in swap data repositories for the benefit of market participants and regulators. To assure data quality, the OFR continues to call on regulators to require the use of data standards in regulatory reporting.

- A description of OFR progress in filling gaps in data needed to monitor and analyze threats to financial stability, especially those arising in market-based activities — so-called shadow banking activities. A key initiative involves a pilot project with the Federal Reserve to collect data measuring the market for bilateral repurchase — or repo — agreements. A repo is essentially a collateralized loan, when one party sells a security to another party with an agreement to repurchase it later at an agreed price. Repos are an important source of short-term funding for the financial system. The U.S. repo market provides more than $3 trillion in funding every day. The bilateral repo market, which constitutes half of the total market, is not only opaque, but also vulnerable to runs and fire sales of collateral. The chapter also discusses the OFR's analysis of hedge fund leverage using new data collected by the Securities and Exchange Commission through Form PF. Although the analysis is preliminary, Form PF data have provided detailed insights into the activities of hedge funds and other private funds.

A copy of the *OFR 2014 Annual Report* is available here.